

Gulf States Utilities, the Public Service Commission, and the Supreme Court: On Raising the Electric Rates

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hypothetical case in which the only evidence amassed against the defendant is circumstantial⁶² and the victim is unavailable to testify and, in fact, has never made a sworn statement on record. To allow a witness to testify as to what the absent victim told him, as much as several hours after the incident concerning the details of the attack, would be tantamount to trial of the defendant without furnishing him his constitutionally guaranteed right to confront and cross-examine his accusers. It is certainly not suggested that the supreme court would knowingly sanction such an obvious travesty of justice; however, it is submitted that to continue the sanctioning of the type of evidence offered in the *Hatcher* case without any meaningful inquiry into its necessity and trustworthiness is to set the stage for this hypothetical travesty of justice to become a reality.

Estelle Mahoney

GULF STATES UTILITIES, THE PUBLIC SERVICE
COMMISSION, AND THE SUPREME COURT: ON
RAISING THE ELECTRIC RATES

The Louisiana Public Service Commission denied a request by Gulf States Utilities for an increase in its electric rates.¹ On appeal from a district court judgment which had generally upheld the Commission's denial,² the Louisiana Supreme Court affirmed the

only issue is the consent of the victim of *that rape* evidence of other offenses is usually inadmissible. *Id.* at 1034 n.1. The defendant was not convicted of the forcible rape charge or of a lesser included offense, however, and the court viewed any prejudice that the defendant might have suffered in his defense to that prosecution as "inconsequential." *Id.* at 1034.

62. For a thorough discussion of circumstantial evidence (i.e., all offered evidentiary facts not being assertions from which the truth of the matter asserted is desired to be inferred) as distinguished from testimonial evidence, see 1 J. WIGMORE, EVIDENCE § 25 (3d ed. 1940). See also C. McCORMICK, *supra* note 4, at § 185.

1. Gulf States Utils. Co., 20 P.U.R. 4th 147 (La. P.S.C. 1977). The increase in rates would have produced additional revenues of \$23,750,000.

2. The district court had, however, granted an attrition adjustment. Attrition is the tendency of a utility's rate of return to diminish because of rising expenses due to inflation. *Central Main Power Co. v. Public Utils. Comm'n*, 382 A.2d 302, 316 n.18 (Me. 1978). For a discussion of rate of return, see text at notes 3-7, *infra*. Utilities typically present their rate requests to regulatory agencies using their most recent figures for expenses, revenues, and valuation. See, e.g., *New England Tel. & Tel. Co. v. Department of Pub. Util.*, 354 N.E.2d 860, 865 (Mass. 1976). When the matter is finally concluded a year or two later, the rate relief granted will inevitably produce a smaller

Commission's order and *held* that the Commission did not act unreasonably or arbitrarily (1) in using a rate formula which did not allow Gulf States to pass on to consumers costs of certain construction work in progress, and (2) in not allowing Gulf States to "normalize" its income tax expenses in order to artificially inflate the rate base. *Gulf States Utilities Co. v. Louisiana Public Service Commission*, 364 So. 2d 1266 (La. 1978).

The regulation of public utility rates involves a balancing of investor and consumer interests.³ Although regulation is not meant to guarantee revenues, the financial integrity of the business requires that there be enough revenue to cover both the utility's operating costs and its capital costs.⁴ The return to the stockholder should be commensurate with returns on investments in other businesses with corresponding risks and should be sufficient to assure confidence in the financial integrity of the utility so that it is able to maintain its credit and attract capital.⁵ In order to regulate utility rates accordingly, four separate factors are calculated:

1. The amount of *revenues* generated under the present rate structure.
2. The *operating expenses*, including maintenance, depreciation, and taxes, incurred to produce revenues.
3. The *rate base*, *i.e.*, the value of the property, plant, and equipment (less accumulated depreciation) which provide the service, and on which a return should be earned.
4. The *rate of return*, a percentage figure which, when applied to the rate base, will generate revenues sufficient to cover

rate of return than intended, since it is based on figures which, though accurate when recorded, have since been elevated by inflation. Of the methods devised by regulatory agencies to deal with attrition, two seem to be the most effective and accurate. The first indexes the rate of return to the inflation rate. As inflation rises, the rate of return is permitted to rise accordingly. See West, *Adjusting Rates to Cost of Capital*, PUB. UTIL. FORT., Sept. 15, 1977, at 19, 22. The second method deals with the problem from the other end of the rate-making process: the rate base itself is indexed to the economy. This is accomplished by adjusting the rate base to reflect replacement rather than original cost of plant in service. See Spiro, *Alternative Methods of Inflation Adjustment in Utility Rate Making*, PUB. UTIL. FORT., March 2, 1978, at 30, 30-31. In the instant case, the supreme court overturned the district court's attrition adjustment, finding Gulf States' rate of return to be adequate without it. *Gulf States Utils. Co. v. Louisiana Pub. Serv. Comm'n*, 364 So. 2d 1266, 1274 (La. 1978). Dissenting Justice Summers agreed that the attrition adjustment request should be denied, 364 So. 2d at 1282 (Summers, J., dissenting). Since attrition exists only in relation to the rate of return, as long as the rate of return is a fair one, no accommodation for attrition should be made. The issue is not treated further in this note.

3. See, *e.g.*, *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (dealing with the federal rate-making process).

4. *Id.*

5. *Id.* at 603-05.

costs and give investors a fair return on their investment.⁶

Algebraically, the rate of return is derived from the following formula: $R = O + (V-D)r$, in which R represents the amount of revenue deemed sufficient; O, the operating expenses; (V-D), the rate base (value less accumulated depreciation); and r, the rate of return.⁷ Once the values for these elements are determined, the public utility rates are then set in order to generate the required revenues. All of these elements are variables; fluctuation of any one of them will produce a concomitant change in the rates consumers pay. Thus, the proper determination of these figures not infrequently is the subject of controversy at rate hearings. Discussion of the instant case requires an understanding of two factors involved in the valuation process: construction work in progress (CWIP) and depreciation.

The treatment of CWIP is an often-argued bone of contention at rate proceedings.⁸ Traditionally, regulatory agencies have required that the rate base include only property "used and useful" in rendering the utility service.⁹ Under this principle, present consumers are obliged to pay a rate of return only on the property that actually provides the service. By definition, CWIP is not in service; hence, rate-payers have not been required to pay for it, and the amount has not been included in the rate base.¹⁰ Thus, utilities have not been allowed to charge their customers for the capital costs associated with replacement of plant being used up by consumers or expansion necessitated by increased demand. To ameliorate the harshness of this result, regulatory agencies have developed various methods of treating CWIP.

A large number of jurisdictions employ the interest during construction method (IDC),¹¹ according to which the amounts expended

6. 1 A. PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION 45 (1969).

7. *Id.* at 139.

8. See, e.g., *Goodman v. Public Serv. Comm'n of the Dist. of Columbia*, 497 F.2d 661 (D.C. Cir. 1974); *Alabama Power Co.*, 97 P.U.R.3d 371 (Ala. P.S.C. 1972); *Municipality of Anchorage*, 19 P.U.R. 4th 278 (Alas. P.U.C. 1977); *Florida Gas Co.*, 13 P.U.R. 4th 255 (Fla. P.S.C. 1975); *South Cent. Bell Tel. Co.*, 15 P.U.R. 4th 391 (Miss. P.S.C. 1976); *Texas Power & Light Co.*, 20 P.U.R. 4th 243 (Tex. P.U.C. 1977).

9. See, e.g., *Mystic Valley Water Co.*, P.U.R. 3d 23 (Conn. P.U.C. 1969); *Boston Edison Co.*, 6 P.U.R. 4th 77 (Mass. Dep't Pub. Util. 1974); *Union Elec. Co.*, 81 P.U.R.3d 265 (Mo. P.S.C. 1969); *Public Serv. Co. of New Mexico*, 82 P.U.R.3d 362, 369 (N.M. P.S.C. 1970); *Catawba Water Supply, Inc.*, 94 P.U.R.3d 197 (N.C. Util. Comm'n 1972).

10. A. PRIEST, *supra* note 6, at 174-75.

11. See, e.g., *Georgia Power Co.*, 3 P.U.R. 4th 375 (Ga. P.S.C. 1973); *New England Tel. and Tel. Co.*, 100 P.U.R.3d 189, 193 (Mass. Dep't Pub. Util. 1973); *New England Tel. and Tel. Co.*, 84 P.U.R.3d 130, 155 (Mass. Dep't Pub. Util. 1970); *Northwestern Bell Tel. Co.*, 8 P.U.R. 4th 75 (Minn. P.S.C. 1974); *South Cent. Bell Tel. Co.*, 5 P.U.R. 4th 113 (Miss. P.S.C. 1974); *Northwestern Bell Tel. Co.*, 2 P.U.R. 4th 312 (Neb. P.S.C. 1974); *New York Tel. Co.*, 2 P.U.R. 4th 1 (N.Y. P.S.C. 1973); *Mountain States Tel. and Tel. Co.*, 90 P.U.R.(n.s.) 107, 118 (Utah P.S.C. 1951); *Central Vermont Pub. Serv. Corp.*, 94

for CWIP are completely excluded from the rate base. A bookkeeping entry for the cost of capital is made, however; and, when the plant does go into service, the rate base will include the total cost, including the interest paid out for the capital while the plant was being constructed.¹²

Allowance for funds used during construction (AFUDC) is a second method by which regulatory agencies allow for CWIP in the rate of return formula.¹³ Under this approach, followed in Louisiana,¹⁴ the utility is allowed to include its CWIP expenditures in the rate base, but an offsetting adjustment is added to income.¹⁵ Thus, the inclusion of CWIP in the rate base is fictional, not actual. The net result is the same as with the IDC method: when the plant goes into service, all costs, including interest, are reflected in the rate base in order that the investors may recoup their entire investment.¹⁶ As in the instant case, utility companies often argue for in-

P.U.R.3d 34 (Vt. Pub. Serv. Bd. 1972).

12. See *Communications Satellite Corp.*, 56 F.C.C.2d 1101, 1132 (1975).

13. A. PRIEST, *supra* note 6, at 179. See, e.g., *Southern Bell Tel. & Tel. Co.*, 98 P.U.R.(n.s.) 511 (Ky. P.S.C. 1953); *Michigan Bell Tel. Co.*, 85 P.U.R.3d 467, 473-74 (Mich. P.S.C. 1970); *Detroit Edison Co.*, 83 P.U.R.3d 463, 469 (Mich. P.S.C. 1971); *North Carolina ex rel. Utils. Comm'n v. Morgan*, 277 N.C. 273, 177 S.E.2d 405, 416-17 (N.C. 1970).

14. 364 So. 2d 1266, 1270 (La. 1978).

15. Although the rate base is inflated by the CWIP amounts, the utility's income figure is increased artificially by a corresponding amount sufficient to offset the effect of the rate base increase, with the result that the revenue required by the utility is not affected by the mathematical adjustments. A. PRIEST, *supra* note 6, at 179.

16. An illustration may be helpful here. Assume Utility X has current plant in service valued at \$1,000,000, CWIP is valued at \$100,000, its current revenues are zero, and the rate of return deemed to be fair is 10%.

Under the IDC method, the revenue requirement would be \$100,000, computed as follows:

Rate base	Fair rate of return	Revenue requirement
\$1,000,000	10%	\$100,000
(\$100,000 CWIP excluded)		

Under the AFUDC method, the computation looks like this:

Rate base	Fair rate of return	Revenue requirement
Plant in service		
\$1,000,000		
CWIP		
100,000		
TOTAL	10%	\$110,000
\$1,100,000		

The final revenue requirement is still only \$100,000, however, because of the offsetting addition to income which must be made:

Revenue requirement	\$110,000	
less "income" due to AFUDC:	-10,000	(computed at 10% of CWIP)
Final Revenue Requirement	\$100,000	

clusion of CWIP in the rate base without a corresponding offset to income in an attempt to charge current rate-payers for the construction of facilities not yet in service.¹⁷

Depreciation of plant and equipment in relation to the rate base is another frequently litigated source of controversy.¹⁸ Under the Internal Revenue Code, businesses have the option to deduct as depreciation expense for the earlier years of an asset an amount greater than that otherwise allowed them for depreciation of assets.¹⁹ This process, known as accelerated depreciation, results in a lower tax liability for those years. If the same artificially high level of depreciation is used in rate proceedings for calculating the value of the rate base, the rate base will, to that same extent, be artificially low. Desiring the highest possible rate base upon which to determine the rate of return, utilities traditionally argue for "normalization" of the depreciation expense.²⁰ Normalization is the practice of using accelerated depreciation for income tax purposes and straight-line (*i.e.*, normal, or pro rata) depreciation for rate-making purposes.²¹ In this way, the utilities receive the benefit of lower income taxes resulting from the accelerated depreciation, but conversely calculate their rate base on a pro rata level of depreciation. Thus, the utility rates are higher than would be the case if accelerated depreciation were used for rate-making purposes.

However, regulatory agencies often require "flow-through" of the tax benefits to the rate-paying consumers.²² This procedure en-

17. *See, e.g.*, Public Serv. Co. of Colorado, 13 P.U.R. 4th 40, 52 (Colo. P.U.C. 1975); Hartford Elec. Light Co., 6 P.U.R. 4th 209, 230 (Conn. P.U.C. 1974); Iowa Power and Light Co., 20 P.U.R. 4th 397, 401 (Iowa St. Commerce Comm'n 1977).

18. *See, e.g.*, Belvedere Water Co., 83 P.U.R.3d 202, 203 (Fla. P.S.C. 1970); Wisconsin Pub. Serv. Corp., 83 P.U.R.3d 301 (Mich. P.S.C. 1970); Northland Util. Ltd., 85 P.U.R.3d 432, 439-40 (Alta. Pub. Utils. Bd. 1970) (Can.).

19. I.R.C. § 167. Thus, if the plant has a useful life of ten years, with accelerated depreciation the utility can depreciate the plant for income tax purposes approximately 15% the first year, with the amount of depreciation decreasing each year so that in the tenth year only about 3.5% depreciation is taken. *See* I.R.C. § 167(j)(1)(B). Under straight-line, or normal, depreciation, the asset, less salvage value, is depreciated an equal amount (10%) each year.

20. *See, e.g.*, FPC v. Memphis Light, Gas & Water Div'n, 411 U.S. 458 (1973); Iowa Power and Light Co., 20 P.U.R. 4th 397, 406-07 (Iowa St. Commerce Comm'n 1977); New England Tel. & Tel. Co. v. Public Utils. Comm'n, 390 A.2d 8, 18-19 (Me. 1978).

21. New England Tel. & Tel. Co. v. Public Utils. Comm'n, 390 A.2d 8, 18-19 n.4 (Me. 1978).

22. Alabama-Tennessee Natural Gas Co., 52 P.U.R.3d 118 (F.P.C. 1964); Cincinnati Gas and Elec. Co., 35 P.U.R.3d 392, 397 (Ohio P.U.C. 1960). The Court of Appeals for the Fifth Circuit is among those courts approving flow-through. Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (5th Cir.), *cert. denied*, 385 U.S. 847 (1966). For a general discussion of flow-through and normalization, *see* A. PRIEST, *supra* note 6, at 124-38.

tails the passing on to the consumers of the benefits of accelerated depreciation in the form of reduced rates.²³ The rationale behind the flow-through mechanism is that to allow "normalized" depreciation in the rate base is to give deference to fiction over fact. If the utility actually pays only a small amount of taxes by taking a large chunk of depreciation expense, to allow it to reduce its rate base by a lower "normal" depreciation percentage will in effect charge present consumers for taxes not really paid by the utility.²⁴

The reasonableness of the Public Service Commission's²⁵ denial of a request for a rate increase was before the Louisiana Supreme Court in *Gulf States Utilities Co. v. Louisiana Public Service Commission*.²⁶ At the outset, the court delineated the standard of review applicable to appeals from the decisions of the Commission: the question is always whether the Commission acted unreasonably or arbitrarily in establishing the rates. Relevant to this inquiry is the question of whether the total effect of the order is unjust or unreasonable.²⁷ Additionally, the court observed that the decisions of the Commission carry a presumption of validity and the opponent of the order bears a heavy burden of proving otherwise.²⁸

Gulf States, in attempting to persuade the court that its rate of return was too low, argued that: (1) expenditures for certain pollution control and fuel-conversion equipment under construction should have been added into the rate base without adding a cor-

23. A. PRIEST, *supra* note 6, at 124.

24. See *Alabama-Tennessee Natural Gas Co. v. FPC*, 359 F.2d 318, 336 (5th Cir.), *cert. denied*, 385 U.S. 847 (1966).

25. The Louisiana Public Service Commission (P.S.C.) is an administrative agency vested with broad discretionary powers. It is unclear whether the P.S.C. is subject to the state Administrative Procedure Act (A.P.A.), LA. R.S. 49:951-68 (Supp. 1966 & 1978). Compare LA. R.S. 49:967 (Supp. 1974 & 1978), with LA. R.S. 49:968(F)(4) (Supp. 1966). If applicable, the A.P.A. would provide different appellate procedure and a different standard of review than set forth under the statutory and constitutional provisions which provide for the working of the P.S.C. See *Louisiana Consumers' League v. Louisiana Pub. Serv. Comm'n*, 351 So. 2d 128 (La. 1977) (rule-making provisions of A.P.A. held not applicable to P.S.C.). But see Karré, *Louisiana's "New" Administrative Procedure Act*, 35 LA. L. REV. 629, 636 (1975) (arguing P.S.C. could claim exemption from A.P.A. on state constitutional grounds).

The power to fix just and reasonable rates is delegated to the Commission in the state constitution as well as by statute. LA. CONST. art. IV, § 21(B); LA. R.S. 45:1176 (1950).

26. 364 So. 2d 1266 (La. 1978).

27. *Id.* at 1267-68. See also *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *South Cent. Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n*, 352 So. 2d 964 (La. 1977); *Louisiana Power & Light Co. v. Louisiana Pub. Serv. Comm'n*, 343 So. 2d 1040 (La. 1977); *Baton Rouge Water Works Co. v. Louisiana Pub. Serv. Comm'n*, 342 So. 2d 609 (La.), *cert. denied*, 434 U.S. 827, (1977).

28. 364 So. 2d at 1267-68.

responding AFUDC offset to income, because this equipment would benefit present as well as future consumers;²⁹ (2) accelerated depreciation should have been normalized to reflect a larger rate base;³⁰ and (3) the "end result" of the rate increase denial would be a cash-flow crisis for the company, leaving it with revenues insufficient to maintain financial integrity and attract the capital necessary for fuel-conversion and pollution control construction.³¹ Labelling both the depreciation and CWIP issues as matters of policy, the court held that the Commission did not act unreasonably or arbitrarily in refusing to normalize the depreciation and in refusing to pass the cost of pollution and fuel-conversion construction on to present rate-payers.³² Unconvinced that Gulf States would suffer any significant financial detriment without the rate increase, the court dismissed the end result argument as well, noting that the company still enjoyed a high (AA) bond rating and that the 13.84% return allowed on equity was quite sufficient.³³

Traditional regulatory policy supports the Commission's decision not to allow any inclusion in the rate base for CWIP without a corresponding AFUDC adjustment to income. Justice Tate, writing for the majority, quoted the following passage from the Commission's order:

"The question . . . is philosophical in nature: should a present-day rate-payer be required to pay for all or part of the capital costs associated with a plant not used or useful to him . . . ? [I]t is appropriate to adhere to the accepted regulatory principle that rate-payers should pay only for that plant which presently benefits them."³⁴

But the problem of CWIP is not merely philosophical, nor so simple as to be resolved by the armchair assertion that rate-payers should pay only for that plant in service which benefits them. This principle of matching existing rate-payers with existing services is based on the assumption, arguably erroneous, that present energy consumers are as a group identifiably distinct from those who will use energy five or ten years from now.³⁵ The weakness of this assumption is apparent. Energy consumption is a lifelong process. To deny utilities the right to charge consumers for plant not yet in

29. *Id.* at 1280.

30. *Id.* at 1269.

31. *Id.*

32. *Id.* at 1271.

33. *Id.* at 1273.

34. *Id.* at 1271.

35. Johnson, *CWIP: Planning For The Rate Case*, PUB. UTIL. FORT., Aug. 2, 1979, at 15, 20.

service based on the premise that they receive no benefit from the plant is unrealistic, since these same rate-payers will derive their energy from the plant and pay for it when it comes on line.³⁶ Furthermore, this matching principle is not as sacrosanct as the regulators imply; it is not adhered to throughout the regulatory process. A glaring example of its inconsistent application is seen in the treatment of tax benefits. Regulatory commissions allow utilities to lower their taxes by taking interest deductions on their CWIP capital expenditures. The result is lower taxes while construction work in progress (CWIP) is going on, and thus lower rates for the present consumers. Future consumers who must pay for the full CWIP expense do not get the interest deduction benefit, although theoretically the money was borrowed, and the plant built, to satisfy their needs.³⁷

Additionally, the impact of the AFUDC method on the utility's financial integrity should be examined. Inclusion of CWIP in the rate base with an offsetting adjustment to income results in a cash-flow problem for the utility and presents a false picture of its earnings as well. Once complacently accepted when construction costs were low and the time required for construction short, AFUDC is today being questioned before regulatory agencies with increasing fervor as costs soar and the time necessary for new plant construction perennially increases.³⁸ The AFUDC adjustment to income now comprises 40% of earnings for the average utility in those states which use the AFUDC method, and is up to 70% for some.³⁹ This high percentage of AFUDC in earnings presents a distorted picture of the utility's financial health, because the AFUDC amount is not real dollars available for capital costs or dividend payments, but rather only a bookkeeping entry representing a future privilege to charge rate-payers for the CWIP. Analysts agree that there is an inverse relationship between the percentage of AFUDC and the financial health of the utility.⁴⁰

36. Consumers fall into two groups: (1) industry, which theoretically enjoys perpetual existence, and (2) individuals. Those individuals who die before the plant is in service will generally be succeeded in their electricity consumption by their descendants. *Id.*

37. See Coughlan, *Allowance for Funds in Construction: Accounting Stepchild and Regulatory Football*, PUB. UTIL. FORT., Nov. 4, 1976, at 26, 30.

38. Today, the investment in CWIP equals about 20% of utilities' total net plant. *Why There Will Be a Money Crunch*, BUS. WEEK, May 28, 1979, at 111, 120 [hereinafter cited as *Money Crunch*]. The lead time for a nuclear plant is now about twelve years; for a coal plant, eight years. *A Dark Future for Utilities*, BUS. WEEK, May 28, 1979, at 108, 111 [hereinafter cited as *Dark Future*].

39. *Money Crunch*, *supra* note 38, at 120 & 124.

40. See Mattutat, *A Pragmatic Approach to Construction Work in Progress*, PUB. UTIL. FORT., March 3, 1977, at 31, 37; Trout, *A Rationale for Preferring Construction Work in Progress in the Rate Base*, PUB. UTIL. FORT., May 10, 1979, at 22, 23.

Although theoretically proper according to accounting principles (the utility will eventually recover its costs of capital when the plant goes into service), use of the AFUDC method presents serious cash-flow problems for the electric utility with a large percentage of AFUDC income in its earnings.⁴¹ Most of the capital needed for utility construction must be acquired externally.⁴² Unable to include CWIP in the rate base without a corresponding adjustment to income, the utilities cannot earn a return on their construction investment until the plant goes into service. Hence, the cost of borrowing the construction capital must come from some source other than the rate-payers. Utilities often turn to the bond market to meet these capital needs, but rising AFUDC figures cast an increasingly longer shadow on their ability to borrow money there.⁴³ Utilities with a large proportion of AFUDC in their earnings are perceived by investors as less than financially healthy, and the bond ratings of these utilities subsequently suffer.⁴⁴ As investors are being advised to trim utility holdings from their portfolios,⁴⁵ meeting these capital costs during the years that new plant is being constructed presents utilities with an increasingly severe financial predicament; this predicament is not adequately accounted for in present rate-making procedures.

Finally, it should be observed that inclusion of CWIP in the rate base would result in more gradual rate increases for consumers.⁴⁶ At the heart of the CWIP problem lies the use of original cost in the rate base. In most jurisdictions, as in Louisiana, regulatory commissions calculate the value of the plant in service in the rate base at its original cost.⁴⁷ Theoretically, as the plant depreciates each year, the amount of the depreciation is set aside in a depreciation reserve account in order to provide a source of funds to replace the plant as it becomes obsolete.⁴⁸ Since the plant is figured into the rate base at its original cost, as opposed to the present-day cost of replacing the

41. Gulf States advanced this cash-flow argument in support of its position. 364 So. 2d at 1269.

42. The figure quoted currently is 60%. *Money Crunch*, *supra* note 38, at 111.

43. See Fitzpatrick & Stitzel, *Capitalizing an Allowance for Funds Used During Construction: The Impact on Earnings Quality*, PUB. UTIL. FORT., Jan. 19, 1978, at 18, 19.

44. *Money Crunch*, *supra* note 38, at 124.

45. *Id.* at 114.

46. Mattutat, *supra* note 40, at 37.

47. CLARK, DODGE & CO., AN OUTLINE OF ELECTRIC UTILITY REGULATION BY STATES 40 (1965); A. PRIEST, *supra* note 6, at 141.

48. A. PRIEST, *supra* note 6, at 112-13 & 118-19.

plant, the depreciation reserve⁴⁹ is necessarily limited to the original cost as well.

This regulatory practice is premised upon the unrealistic assumption that an original cost depreciation reserve will adequately finance a new plant.⁵⁰ In reality, today's energy consumers are using up the useful life of energy plants while paying rates based upon the original cost of these plants. Once the plant becomes obsolete, it must be replaced; the depreciation reserve left behind is woefully inadequate for the purpose. The result is that utilities must find large amounts of outside capital to build new plants in order to replace the old which is being depleted through the use of present consumers; this outside capital must be forthcoming if the utility is merely to "stay even."⁵¹

Combining original cost figures with the exclusion of CWIP from the rate base results in a sudden and large stair-step rate increase when the new plant goes into service. Rates are kept artificially low⁵² until the plant actually produces electricity, at which time the utility is finally allowed to recover its costs. At this time, rates jump up to reflect the true cost of the electricity. It is submitted that use of replacement cost,⁵³ coupled with inclusion of CWIP in the rate base,⁵⁴ would produce a more gradual rate increase curve. Thus, the increase in consumers' rates would closely parallel the cost to the utility, and the utility would be better able financially to under-

49. The depreciation reserve is a bookkeeping account into which the amount of depreciation taken annually is accrued. This depreciation reserve account is represented by D in the rate-making equation found in the text at note 7, *supra*.

50. The average capital cost per kilowatt hour of a coal-fired plant has risen from \$144 in 1970 to \$1096 for one scheduled to go on line in 1987. For nuclear plants, the corresponding figures are \$165 and \$1861. *Dark Future*, *supra* note 38, at 109.

51. See Public Serv. Co. of New Mexico, 8 P.U.R. 4th 113, 118 (N.M. P.S.C. 1975).

52. The rates are artificial in the sense that the rates in effect before a new plant goes into service (based as they are on the original cost of the present obsolete plant, without any consideration for the new plant under construction) do not reflect the true cost of the electricity provided. This is analogous to the low prices paid for gasoline under regulation; the price paid does not reflect the true market cost, i.e., the price that would obtain absent the regulation.

53. Replacement cost is being considered elsewhere in varying degrees. See, e.g., Mebane Home Tel. Co., 19 P.U.R. 4th 290 (N.C. Utils. Comm'n 1977); Piedmont Natural Gas Co., 18 P.U.R. 4th 478 (N.C. Utils. Comm'n 1977).

54. About ten states allow CWIP in full in their rate base, and the Federal Energy Regulatory Commission now allows it as well in certain instances. FPC Order No. 555, 41 Fed. Reg. 51,392 (1976); *Money Crunch*, *supra* note 38, at 120. Approximately one-half of the states permit CWIP to some degree in the rate base. FPC Order No. 555, 41 Fed. Reg. 51,392 (1976), citing NAT'L ASS'N OF REGULATORY UTILITY COMM'RS, 1974 ANNUAL REPORT ON UTILITY AND CARRIER REGULATION 391-92 (1976).

take construction necessary to adequately meet present and future energy demands.

The court in the instant case took little notice of these problems inherent in the traditional treatment of CWIP, choosing instead to defer faithfully to the judgment of the Public Service Commission. Inasmuch as the Commission is an elected body,⁵⁵ and therefore arguably more easily influenced by political pressures and aspirations, it is especially important that the court upon review examine the Commission's order with something more than a deferential attitude. It is submitted that, rather than blindly following the inequitable and illogical matching principle, the regulators and the courts should instead consider whether the investment is a prudent one; *i.e.*, is it necessary to insure adequate supplies of electricity to meet reasonably expected future demands?⁵⁶ If so, the cost of the construction should be included in the rate base.⁵⁷ The problems inherent in the AFUDC method would thus be eliminated.

The arguments in favor of including CWIP in the rate base are especially persuasive in the context of the instant case. Gulf States contended for actual inclusion (*i.e.*, without offset) in the rate base of CWIP amounts expended for pollution control and fuel conversion.⁵⁸ Arguably, this request was very reasonable. Required by the federal government, this equipment for pollution control will benefit all area residents, whether or not customers of Gulf States. As for the fuel conversion construction, it should be noted that the Powerplant and Industrial Fuel Use Act of 1978⁵⁹ mandates that there be no construction of natural gas or oil-fired plants after 1980, and that such already existing facilities be converted to accept other fuels by 1990.

55. LA. CONST. art. IV, § 21. It has been noticed elsewhere that unresponsive commissions are often run by elected officials whose reelection hinges on their ability to keep voters' electric bills down. *The Regulatory Factor in Buying Stocks*, BUS. WEEK, May 28, 1979, at 114.

56. Since a large portion of Gulf States' CWIP is devoted to the construction of the River Bend nuclear plant, some readers may view the plea for actual inclusion of CWIP in the rate base as an affirmation of the use of nuclear power. No such indorsement is intended. According to the approach advocated for dealing with CWIP, the prudent investment inquiry would necessarily entail a socially responsible decision as to the wisdom of nuclear power investment.

57. This "prudent investment" inquiry is almost universally recognized in a similar area of rate regulation. Telephone companies have long been allowed a return on equipment investment which, although not presently used, is reasonably expected to be necessary in the foreseeable future. Thus, it has been held that a 115 kilovolt line could be properly included in the rate base, although it was only then being used at a 48 kilovolt level. *Latourneau v. Citizens Utils. Co.*, 125 Vt. 38, 44-45, 209 A.2d 307, 313 (1965).

58. 364 So. 2d at 1270 & 1280.

59. 42 U.S.C.A. §§ 8301-483 (1978).

The essence of the Act is that all electric utilities will have to convert to some other alternate fuel (e.g., coal or nuclear power) in the near future. Each of these requires substantial cash outlays. In addition to the arguments discussed above for inclusion of CWIP in the rate base, a strong argument can be made that whenever a regulated utility is required by law to undertake construction, the utility should likewise be able to charge its rate-payers for the capital costs associated with that construction. The matching principle is inconsistent with this rationale. All rate-payers, present and future, are benefited by pollution control and conversion modifications. Significantly, the Federal Energy Regulatory Commission now allows inclusion in the rate base of CWIP which is necessitated by pollution control or fuel-conversion requirements imposed upon industries that it regulates, on the premise that "the profligacy of the present generation . . . requires the new facilities."⁶⁰

As for the issue of the normalization of the utility's depreciation expense, the lines are not as sharply drawn. Sound opposing policies compete for recognition. Accelerated depreciation came into being as an incentive to enter business and invest on the theory that a business in its early years is more likely to survive if given a tax break. Investment in new equipment is spurred by the knowledge that a great part of the outlay can be "written off" in the first few years. The economy is stimulated, and the government will recover its share in the later years of "lean" depreciation.⁶¹

The utilities argue forcefully that these purposes for allowing accelerated depreciation in income tax accounting are thwarted by the flow-through requirement. If the plant value in the rate base is likewise depreciated liberally for rate-making purposes, the argument goes, the revenues allowed will thus be lowered as well, and the tax "break" will be no break at all for the utilities⁶²—they take accelerated depreciation only to end up with correspondingly lower revenues.

The argument at first blush appears persuasive, but closer examination reveals that it assumes too much. The flawed assumption is that Congress intended to benefit regulated utilities as well as private enterprise with its liberalized depreciation legislation.⁶³

60. FPC Order No. 555, 41 Fed. Reg. 51,392, 51,394 (1976).

61. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 24, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4048; S. REP. NO. 1622, 83d Cong. 2d Sess. 26, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4656.

62. Alabama-Tennessee Natural Gas Co., 52 P.U.R.3d 118, 122 (F.P.C. 1964); City of Alton v. Illinois Commerce Comm'n, 19 Ill. 2d 76, 89-90, 165 N.E.2d 513, 521 (1960).

63. A. PRIEST, *supra* note 6, at 124-25.

Arguably, the tax advantages of accelerated depreciation are not needed by a public utility whose rates and profits are practically insured by government regulation, restrictive entry, and, hence, insulation from competition. Rather, the depreciation legislation should serve the new business person, for whom the financial risk inherent in the free enterprise system is a reality.

A further policy consideration is the likelihood that these deferred taxes will never actually be paid if the utility is either economically stable or growing.⁶⁴ The heart of the utilities' argument is that treatment of deferred taxes is merely a matter of timing.⁶⁵ Thus, to use straight-line depreciation for rate-making purposes is appropriate, since the taxes that are deferred because of the liberalized depreciation laws will be paid in those years of "lean" depreciation ahead. As the court recognized, this proposition is valid only if the individual assets upon which accelerated depreciation is taken are retained until fully depreciated.⁶⁶ With a stable or growing company, however, assets are usually replaced before the lean years of depreciation arrive; the new asset is depreciated as liberally as possible, and the cycle goes ever on. The result is that the taxes are not deferred, but are actually avoided.⁶⁷ To allow a "normalization" increase in a stable company's rate base on the assumption that these taxes will be paid in the future is a delusion at best and conscious ignorance at worst. The result is that consumers compensate the utility for expenses which are never actually incurred.⁶⁸

Gulf States also contended that the "end result" of the denial of their rate increase request would be to leave them in a precarious

64. 364 So. 2d at 1275-76 app. 1; A. PRIEST, *supra* note 6, at 125; Davidson, *Accelerated Depreciation and the Allocation of Income Taxes*, 33 ACCOUNTING REV. 173, 179-80 (1958).

65. The assertion is that, after the total depreciation period is over, the same amount of taxes will have been paid, regardless of the method of depreciation used. 364 So. 2d at 1275-76 app. 1.

66. *Id.*

67. See *Alabama-Tennessee Natural Gas Co. v. FPC*, 359 F.2d 318, 336 (5th Cir.), *cert. denied*, 385 U.S. 847 (1966).

68. According to figures compiled by the P.S.C., in the last twenty-five years, the "reserve" set aside by Gulf States which represents the income taxes "deferred" has increased annually, from \$737,000 in 1954 to \$103,718,000 in 1977. In its 1977 taxes, Gulf States enjoyed a net income of more than \$65,000,000, deferred tax savings of \$13,424,000, and paid federal income taxes exclusive of capital gains tax, of only \$3,290,000. Brief for Appellee at 20, *Gulf States Util. Co. v. Louisiana Pub. Serv. Comm'n*, 364 So. 2d 1266 (La. 1978). Imprudent overinvestment may be a further result of deferring payment of taxes. According to the Averch-Johnson hypothesis, an overgenerous rate of return induces regulated companies to overinvest in capital assets. Averch & Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 AM. ECON. REV. 1052 (1962). See D. BOIES & P. VERKUIL, *PUBLIC CONTROL OF BUSINESS* 146 & 192 (1977).

financial position, unable to attract capital or maintain their financial integrity. The utility pointed to certain indicia as evidence of this contention, including the fact that the company had had to borrow money in order to pay dividends.⁶⁹ The court countered this argument with the observation that borrowing money is a routine business transaction undertaken in order to raise capital to meet various costs, including not only the payment of dividends, but wages and other expenses as well.⁷⁰ Pointing out that Gulf States still enjoyed an AA bond rating and that the company would earn a 13.84% return on equity without the rate increase, the court dismissed the end result argument.⁷¹ Although the court's assessment of the situation in the instant case may be correct, it is submitted that continued refusal to allow earnings on CWIP will bring about the financial crisis Gulf States portrayed.

The United States has for several years been experiencing an economy of inflationary spirals and a dwindling of energy resources, and there are no indications that either of these trends will reverse in the foreseeable future. Unlike free enterprises, regulated industries are unable to respond naturally to the laws of supply and demand in order to weather the storm. Their economic viability rests with the regulatory agencies; a faithful discharge of the agencies duties requires realistic recognition of these trends. Once adopted, this realistic viewpoint will surely entail a reassessment of the traditional treatment of CWIP.

James Winston Pierce, Jr.

ABROGATION OF THE PRINCIPLE OF NONDISCRIMINATION — THE
ADVENT OF VOLUNTARY, RACE-DEPENDENT, PREFERENTIAL
TREATMENT IN EMPLOYMENT

Pursuant to a collective bargaining agreement,¹ the Gramercy, Louisiana plant of Kaiser Aluminum & Chemical Corporation insti-

69. 364 So. 2d at 1272.

70. *Id.* at 1273.

71. *Id.*

1. Effective on February 1, 1974, the master collective bargaining agreement entered into by the United Steelworkers of America and Kaiser Aluminum & Chemical Corporation included an affirmative action plan designed to eliminate conspicuous racial imbalances then present in Kaiser's almost exclusively white craft work forces. The plan removed the requirement of prior craft experience for on-the-job training and